STAFF PAPER

October 2015

IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Cover note

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Introduction

1. At this meeting we will continue the discussion of the IASB's Financial Instruments with Characteristics of Equity research project.

2. The paper that we are discussing at this meeting is **Agenda Paper 5A: Derivatives on own equity**.

3. The objective of that paper is to:

   (a) Discuss the challenges with accounting for derivatives on own equity.

   (b) Discuss how IAS 32 deals with those challenges, including the 'fixed-for-fixed' condition and obligations in derivatives to redeem own equity instruments

4. This cover note also includes:

   (a) Summary of next steps (paragraphs 5–6)

   (b) Summary of discussions to date (paragraphs 7–12)

   (c) Summary table of the classification consequences for some simple instruments (paragraph 13).

Summary of the next steps

5. To address the conceptual challenges, the IASB will need to continue developing each of the potential approaches, including:

   (a) developing potential changes to definitions and additional guidance to implement the underlying rationale of the distinction between liabilities and equity for each approach;

   (b) developing any requirements for additional subclasses within liabilities or within equity to help make the identified assessments under each approach; and

   (c) developing potential changes to the requirements for derivatives on own equity required to implement each approach.

6. To address the application challenges, the IASB will need to discuss the following topics:

   (a) Interaction of contractual rights and obligations with regulatory and legal requirements

   (b) Discuss additional considerations on contingencies and conditionality

   (c) Recognition, derecognition and reclassification of equity instruments (and components), including on settlement, conversion, expiration modification and other events.

Summary of discussions to date

7. In May 2015, we distinguished between the:

   (a) **Conceptual** challenges to do with identifying the underlying rationale of, and approach to, the distinction between liabilities and equity in IAS 32 and in the Conceptual Framework;

   (b) **Application** challenges to do with the consistency, completeness and clarity of the requirements in IAS 32, in particular when those requirements are applied to particular types of transactions in practice.

8. In May 2015 we also set out a roadmap for addressing the above challenges. Importantly we noted that:

   (a) we need to first **identify, confirm (or correct) and reinforce** the underlying rationale of the distinction between liabilities and equity in IAS 32 before attempting to improve the **consistency, completeness and clarity** of the requirements.

   (b) we may need to identify other relevant distinctions between claims that need to be communicated by means other than the distinction between liabilities and equity.

9. In June 2015 we discussed:

   (a) the features of claims against an entity and what makes information about a particular feature relevant to users. In particular, we stated that a feature is relevant if it potentially affects the amount, timing and uncertainty of (the prospects for) future cash flows.

   (b) how information about relevant features is provided in financial statements. In particular we stated that to depict a feature, it must be measured and noted that there must be at least one claim that will be measured as a residual, because of partial recognition and mixed measurement.

   (c) the features that we identified as being relevant are:

      (i) the **type** of economic resource required to be transferred to settle the claim (eg cash, goods or services etc);

      (ii) the **timing** of the transfer of economic resources required to settle the claim (eg specified dates, on demand or at liquidation);

      (iii) the **amount (or quantity)** of economic resources required to be transferred (eg currency units, commodity units, formulas or rates of change, or a share of the net assets of the entity);

      (iv) the **priority (or seniority/rank)** of the claim relative to other claims (eg senior, junior or most subordinate).

10. In July 2015 we discussed the various assessments users might make using information in the statement of financial position and financial performance and which identified features that are relevant to those assessments. We discussed the relevance of the features we identified to:

(a) assessments of financial position:

(i) **Assessment A**: The extent to which the entity is expected to have the economic resources required to meet its obligations *as and when* they fall due.

For this assessment, users need information about the **timing** of required settlement of claims.

If that **timing** is **prior to liquidation (**eg specified dates), then the **amount** and **type** of economic resources that the claim requires the entity to transfer will also be relevant.

(ii) **Assessment B**: The extent to which an entity has sufficient economic resources to satisfy the total claims against the entity *at a point in time* and how any potential shortfall will be distributed amongst claims.

For this assessment, users need information about the **amount** of economic resources required to settle the claim at that point in time.

If that **amount** is **independent** of the availability of the entity's actual economic resources (eg a specified amount of currency units), then the **priority** of the claim on liquidation will also be relevant.

(b) assessments of financial performance:

(i) **Assessment Y**: The extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it and to determine how any potential shortfall in returns will be distributed amongst claims.

For this assessment, users need information about changes in the **amount** of resources required to settle the claim[1].

If that **amount** is independent of the entity's actual economic resources (eg a fixed interest return), then the **priority** of the claim on liquidation will also be relevant.

(ii) **Assessment X**: The returns that an entity has produced on its economic resources.

For this assessment, users need information about changes in its economic resources.

The **timing** of settlement and **type** of economic resources required to settle claims may have implications for the entity's economic resources. However those changes will be recognised as they occur in accordance with requirements for the entity's assets.[2] These features may be relevant to assess physical flows, such as contributions and distributions, for which information is provided elsewhere, such as in the statement of cash flows.

11. In September 2015 we analysed the existing definitions and other related requirements in IAS 32, and identified:

    (a) to what extent those requirements capture the features needed to make the assessments we identified in July 2015; and

    (b) whether there are exceptions, inconsistencies, and gaps in those requirements.

12. In September 2015 we outlined three possible approaches for improvements that we intend to develop further as the project progresses:

    (a) **Approach Alpha**—focuses the distinction between liabilities and equity on the **timing** of required settlement, which is relevant Assessment A. Approach Alpha will classify as liabilities obligations

[1] How the specified amount changes over time is the promised return. For example, the amount could be a contractually specified fixed amount which does not change, or it could change based on a formula such as an interest rate, index rate or underlying asset price.

[2] Given that an entity's financial performance includes changes other than contributions and distributions to claim holders, the **timing** of required settlement and **type** of resource required, are features that determine *when* the distributions of resources will occur, and **what** form that distribution will take. These changes may be relevant for assessing the entity's financial performance as reflected by cash flows (OB20)

to transfer economic resources **prior to liquidation**. All other claims will be classified as equity.

(b) **Approach Beta—**focuses the distinction between liabilities and equity on the **amount** of economic resources required to settle the claim, which is relevant to Assessments B and Y. Approach Beta will classify as liabilities obligations for an **amount independent** of the entity's economic resources. All other claims will be classified as equity.

(c) **Approach Gamma**—focuses the distinction between liabilities and equity on both the **timing** of required settlement *and* the **amount** of economic resources required to settle the claim. Approach Gamma will classify as a liability obligations:

(i) to transfer economic resources **prior to liquidation**; or

(ii) for an **amount independent** of the entity's economic resources.

All other claims will be classified as equity.

Summary of classification under the proposed approaches

13. Classification consequences for some simple instruments:

Instrument	**Alpha**	**Beta**	**Gamma**
Considered in September 2015			
Ordinary bonds	Liability	Liability	Liability
Ordinary shares	Equity	Equity	Equity
Shares redeemable for their fair value	Liability	Equity	Liability
Share-settled bonds	Equity	Liability	Liability
Cumulative pref shares	Equity	Liability	Liability